



Fundamentals of Income Tax for Estates and Trusts

Part II

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Estate Gift & Trust Tax

Technical Resource Panel

June 28, 2005

How is a Trust Taxed?

- IRC §641(b):
 - “ The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. “



Personal Exemptions

- Major differences from individual income taxation
- Personal Exemption (IRC §642(b)(3))
 - Estate \$600
 - Simple Trust \$300
 - Complex Trust \$300 or \$100



The Distribution Deduction

- Estates and Trusts are entitled to a special deduction
 - “The distribution deduction.”
 - IRC §651 – Simple Trusts
 - “there shall be allowed as a deduction in computing taxable income..... the amount of the income required to be distributed”



The Distribution Deduction

Complex Trusts and Estates

- IRC §661
- The deduction will be the total of
 - Amounts required to be paid currently (Tier I)
 - Other amounts paid, credited or permanently set aside. (Tier II)



The Distribution Deduction

In all cases the distribution deduction
cannot exceed distributable net
income (DNI)

IRC §651(b) & IRC §661(c)



What is “Income”

For distribution purposes?

- IRC §643(b)
- “..... the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.”



What is “Income” For distribution purposes?

- First, READ THE GOVERNING INSTRUMENT
- Second, be familiar with your state’s principal and income act.
- Income computed in accordance with the above will be the “income required to be distributed” of a Simple Trust.

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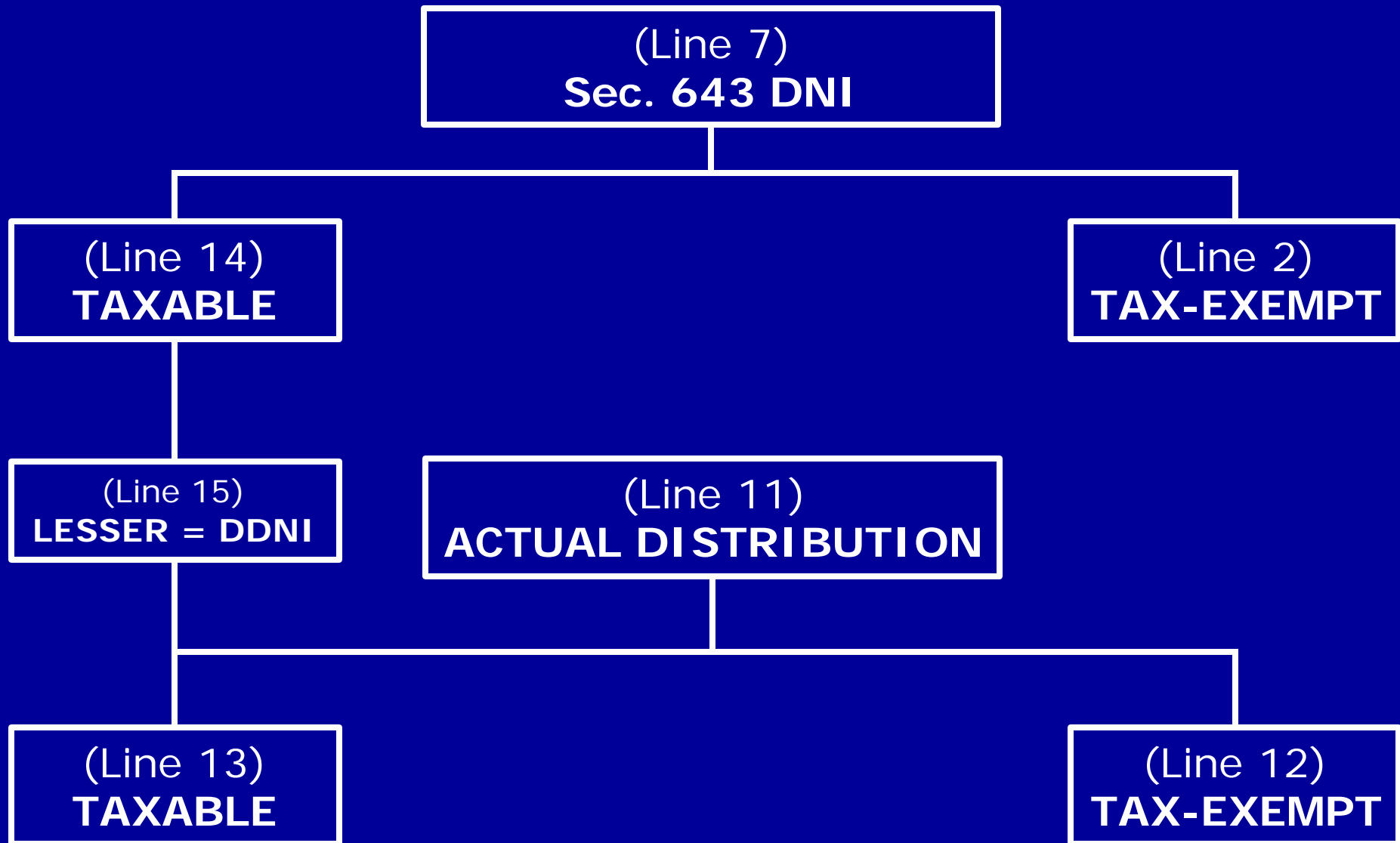
What is DNI?

IRC §643(a)

- Taxable income before
 - Exemption
 - Distribution Deduction
 - Special Deductions
- Add back:
 - Capital Losses
 - Municipal Income (Net of allocable Expenses)
- Subtract:
 - Capital Gains

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DNI Relationships



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Tiers of Distributions

- Tier I – Income required to be distributed
 - This tier receives DNI First!
- Tier II – Other amounts paid credited or otherwise set aside.
 - This tier is taxed on distributions only to the extent there is remaining DNI

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Deductions

- All ordinary & necessary expenses allowed
 - Administration
 - Trustee Fees
 - Litigation Costs
- No double deduction if expense was allowed on Form 706

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Deductions

- Exceptions to “double deduction” rule.
- Deductions “in respect of a decedent” are allowed on both the Form 706 & 1041
 - Property Taxes
 - Accrued Interest Paid

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Deductions subject to 2% limitation

- Expenses that were not occasioned by the creation of the estate or trust will not be subject to the 2% “haircut”
 - IRS is pursuing Investment Advisory Fees as not being unique to trust administration.



How are deductions allocated to classes of DNI?

- Direct expenses are allocated to the class of DNI they relate to
- Indirect expenses are allocated

First to Non-Taxable Income

Remainder to any class of income included in DNI




Distributions in kind

Issue # 1 – Impact on the Trust or Estate

- *When the entity must recognize gain or loss*
- *When can losses not be recognized*
- *The election to recognize gain or loss (643(e)(3))*

Issue # 2 – Impact on the Beneficiary

- *Effect on distribution deduction*
- *Basis of assets distributed*



Impact to Trust or Estate

- Situations where gain/loss must be recognized include situations where such distributions satisfy beneficiary's right to:
 - *receive income in cash*
 - *right to receive a pecuniary sum of money*
 - *right to receive an annuity*
- Other situations

Impact on Beneficiary

- Distribution Deduction/Income to Beneficiary
If Gain or Loss is recognized, then fair market value of asset is used to compute distribution deduction

If Gain or Loss is not recognized, then adjusted basis (prior to distribution) is used to compute the same
- *Exceptions to the rule – non recognition provisions, etc.*
- Basis to Beneficiary of Assets Distributed
Adjusted Basis (in hands of estate/trust)
Plus/Minus: Any Gain or Loss Recognized

CLASS PROBLEM – SIMPLE TRUST

Description	Actual	Adj.	FAI	Adj.	Taxable	Adj.	Sec. 643 DNI
Receipts:							
Interest	25,000	-0-	25,000	-0-	25,000		25,000
Dividends	50,000	-0-	50,000	-0-	50,000		50,000
Capital Gain	20,000	(20,000)	-0-	20,000	20,000	(20,000)	-0-
Return of Capital	20,000	(20,000)	-0-	-0-	-0-		-0-
Business Inc.	10,000	-0-	10,000	-0-	10,000		10,000
Subtotal:	125,000	(40,000)	85,000	20,000	105,000		85,000
<u>Disbursements:</u>							
Mortgage Int.	(20,000)	-0-	(20,000)	-0-	(20,000)		(20,000)
Mortgage Prin.	(5,000)	5,000	-0-	-0-	-0-		
Trustee Fees							
Income	(2,000)	-0-	(2,000)	-0-	(2,000)		(2,000)
Principal	(2,000)	2,000	-0-	(2,000)	(2,000)		(2,000)
Depreciation	(10,000)	10,000	-0-	-0-	-0-		
Subtotal:	(39,000)	17,000	(22,000)	(2,000)	(24,000)		(24,000)
Total:	86,000	23,000	63,000	18,000	81,000		61,000

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DISTRIBUTION DEDUCTION (DDNI)

Schedule B – Form 1041

